IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-356

DAVID B. CHARNAY,

Petitioner,

v.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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Petitioner David B. Charnay prays that a writ of certiorari issue to review the opinion and order of the United States Court of Appeals for the Ninth Circuit, entered respectively on May 7 and July 8, 1976, that reversed an order of the United States District Court for the District of Nevada, which had dismissed the indictment herein for failure to state an offense.

A separate Petition on behalf of Chester C. Davis was filed by his counsel on, or a few days prior to, the date on which this Petition was filed, praying that a writ of certiorari issue to review the same opinion and order. This Petition is largely based upon that Davis Petition. This Petition adopts the Appendix to the Davis Petition as its own. Petitioner prays that this Petition be considered together with the Davis Petition.

Decisions Below

The opinion of the Court of Appeals, not yet officially reported, appears at [1975-76 Transfer Binder] CCH Fed. Sec.L.Rep. ¶ 95,560 and is set forth at page 27a of the Appendix to the aforementioned Petition on behalf of Chester C. Davis. The order of the Court of Appeals denying the petition for rehearing and "explaining and clarifying" its earlier opinion is set forth at page 58a of that Appendix. The order of the District Court is set forth at page 19a of that Appendix.

Jurisdiction

The judgment of the Court of Appeals for the Ninth Circuit was entered on May 7, 1976. By adoption, a timely petition for rehearing was filed on May 21, 1976, and denied on July 8, 1976.

An application on behalf of petitioner Charnay, dated August 4, 1976, was submitted for an order extending the time for filing this Petition. This application was, however, rejected on that date by Mr. Justice Rehnquist, apparently owing to the fact that inadvertently the application was not submitted in compliance with the 10 day rule contained in Supreme Court Rule 34 (2).* Petitioner Charnay, in submitting this Petition, notwithstanding rejection of the above application, respectfully maintains that this Petition ought to be considered by the Court together with the Davis Petition because (1) this is a criminal case, with respect to which type of case the Supreme Court has on various occasions accepted untimely petitions;** (2) this Charnay Petition seeks review of the same opinion

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* A similar application submitted on behalf of Chester C. Davis, in compliance with the 10 day rule, was granted.

** *E.g., Taglianetti* v. *United States*, 394 U.S. 316, n. 1 (1969).

and order for essentially the same reasons as the Davis Petition, and thus it only asks the Court to consider, with respect to Charnay, matters already placed before the Court by the Davis Petition, and to treat Charnay the same as Davis; and (3) no one has been prejudiced by the fact that this petition has been submitted out of time.

The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. May Rule 10b-5 be construed to create a new and different offense of trading manipulation?

2. Is an indictment proper that purports to charge a violation of Rule 10b-5 of the Securities and Exchange Commission (the "Commission") notwithstanding the fact it does not allege that the defendant acted with a specific intent to deceive or defraud someone?

3. Is it a crime to sell stock, or induce others to sell stock, on a national securities exchange, for the purpose of depressing the price of that stock if the sales are bona fide sales involving no deception?

4. May an appellate court, consistent with Due Process, uphold an indictment alleging a violation of the Securities Exchange Act of 1934 (the "Exchange Act") by declaring the conduct charged a crime based on the purpose of the Exchange Act, as it perceives that purpose, rather than by reference to any specific statutory provision or any specific rule or regulation?

Constitutional and Statutory Provisions

The constitutional and statutory provisions involved are set forth in the separately-bound Appendix beginning at page 1a. They include the following:

1. United States Constitution, Amendments V and VI.

2. United States Code, Title 15, Sections 78(i) and 78(j) (Securities Exchange Act §§ 9, 10).

3. Code of Federal Regulations, Title 17, Section 240.10b-5.

Statement of the Case

The indictment purports to charge a crime on the basis of alleged conduct "never heretofore branded improper by judicial decision, Commission rule or determination, or explicit Congressional act." (Concurring Opinion below, 55a.*)

This alleged conduct consisted of guaranteeing three sellers of stock of Air West, Inc. ("Air West") against loss from sales on the American Stock Exchange. Allegedly these guarantees were given to induce directors of Air West to change their minds and accept an offer of Hughes Tool Company ("Hughes Tool") to purchase the assets of Air West, which the Air West shareholders had approved but the directors had rejected by a narrow margin. (9a.) The alleged effect of the sales was to reduce the price of Air West stock on the American Stock Exchange on the date of the sales and to cause "the Air West stockholders who sold their stock in the declining market to receive the

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* References to page numbers of the separately-bound Appendix appear in the format indicated in the text.

proceeds from their sales at artificially depressed prices." (10a.) The government has conceded that unless this alleged conduct violates Rule 10b-5 of the Commission, the indictment fails to state an offense. (33a.)

The indictment represents the second attempt to charge the petitioner and the other defendants with a crime by reason of the alleged guarantee against losses. The District Court dismissed the earlier indictment as "the worst criminal pleading" it had ever encountered. (5a.) That indictment charged primarily that the guarantee against loss on the sale of the Air West stock constituted a manipulation of the market in violation of Section 9(a)(2) of the Exchange Act (15 U.S.C. § 78i(a)(2)). (27a-28a.) The government did not appeal from this dismissal. Id. Instead, it obtained a new indictment that does not charge a violation of Section 9(a)(2), nor does it allege, as did the first, that transactions in a security were effected on a national exchange "for the purpose of inducing the purchase or sale of such security", an essential element of the offense of market manipulation as defined by Congress.

Petitioner and other defendants moved to dismiss this second indictment for failure to state an offense. The prosecution conceded that there was nothing unlawful *per se* in guaranteeing a seller of securities against loss (5a) and that the sales were real, not fictitious. (26a.) The indictment contains no suggestion that the sales were made in a deceptive manner, let alone in a manner that violated any specific rule of the Commission or at a price other than the price that obtained in a free market.

Because the indictment "alleges no false representation or half-truth or omission to state material facts made in connection with the purchase or sale of a security" (24a) and alleges no purpose to induce the purchase or sale of such security by others (22a), the District Court held that the conduct alleged did not violate any statute or regulation and dismissed the indictment.

The Court of Appeals reversed, solely on the basis of the general purpose of the Exchange Act to insure "fair and honest markets." Its opinion recognizes at the outset that "there has been very little litigation concerning the application of [Rule 10b-5] to market manipulation in corporate takeovers, and no case at all involving the specific conduct in which the appellees are alleged to have engaged." (36a.) In the absence of precedent, it turned to the legislative, administrative and judicial history of the Exchange Act and Rule 10b-5 to determine whether the alleged conduct, if true, constituted an indictable offense. Reading Section 10(b) of the Exchange Act flexibly, not technically and restrictively, and Rule 10b-5 as a catch-all regulation operating independently of the statute, it held that market manipulation is a *per se* violation of Rule 10b-5 even if the "manipulation" does not contain the elements of market manipulation contained in Section 9(a)(2) of the Exchange Act and that the conduct alleged "falls within the type of activity which Congress sought to prohibit in enacting the Securities Act and which Rule 10b-5 explicitly prohibits."

In a separate, concurring opinion, Judge Sneed:

> (a) made clear that the court's decision was based upon its assertion of a residual power to outlaw conduct not proscribed by any statute, regulation or decision, if that conduct offended the court's perception of a generalized underlying purpose of the securities laws (55a);
>
> (b) recognized that the court was "eliminating scienter" from a criminal statute (57a);
>
> (c) viewed the indictment as charging so-called "public welfare offenses" that "do not generally, and clearly not in this case, encounter the same demanding constitutional and interpretative standards applicable to other criminal offenses" (53a, 54a, 57a);

(d) conceded that the Court's decision permits a prosecutor to indict on the basis of political considerations rather than legal standards (57a); and

(e) concluded that, although the law, as he read it, left him "no choice but to join my brothers," he found "no satisfaction or pleasure in doing so" (id.).

Nowhere in either opinion is there mention of this Court's decision in *Ernst & Ernst* v. *Hochfelder*, 96 S.Ct. 1375 (1976), which was decided after oral argument but prior to decision. Petitioner filed by adoption a petition for rehearing in which, *inter alia*, he pointed out the conflicts between the decision and the Court's holding in *Hochfelder* that scienter is a necessary element of even a civil action under Rule 10b-5 and that Rule 10b-5 may not be used to nullify the carefully drawn restrictions of the statute as enacted by Congress. The court below denied the petition. It stated that it had considered *Hochfelder* and had concluded that its opinion was consistent with *Hochfelder*, citing the statement in its opinion "that it was necessary for the prosecutor to show an intentional act with 'a realization on the defendant's part that he was doing a wrongful act'" and the statement in the concurring opinion that "the intent necessary * * * is merely that of intending to do the acts prohibited, rather than intent to violate the statute." (60a.)

Reasons for Granting the Writ

On the basis of claimed "residual power" to hold in a criminal case that conduct is proscribed that does not violate the specific terms of any statute or regulation but rather offends against the general purpose of the Exchange Act, the Court of Appeals has reinstated the indictment against petitioner. Review by this Court is required because (a) the decision disregards the teachings of this Court in *Hochfelder* that a court may not rely on a general

purpose to create violations of the Exchange Act; (b) the holding of the court that "manipulation" is a *per se* violation of Rule 10b-5 is in direct conflict with the decision of the Sixth Circuit in *Marsh* v. *Armada Corporation*, 533 F.2d 978 (6th Cir. 1976), *petition for cert. pending*, No. 76-5; (c) the court below has read out of the Act any requirement of scienter other than an intent to do an act that a court later finds to be a violation of law, contrary to the holding in *Hochfelder* that an intent to deceive is an essential element of a Rule 10b-5 offense; (d) the court has created a novel violation of the Exchange Act based on an intent to depress the price of a security without regard to whether a sale is a true sale or made in a manipulative manner; and (e) the decision does great violence to due process rights guaranteed under the fifth and sixth amendments by the use of a court's claimed residual power to subject petitioner to criminal prosecution for what neither he nor the grand jury that indicted him could know was a crime.

The effect of the court's holding, as the concurring opinion below recognized, is to permit indictment on the basis of no firmer standard than which way a prosecutor determines the political winds are blowing and to return to the case-by-case approach to determining what is or is not a violation of the Exchange Act, which approach this Court found to be an unjustifiable burden on the federal courts in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723 (1975).

A. Conflict With *Hochfelder*: The Need For Review With Respect To Statutory Limitations on the Scope of Rule 10b-5 Liability

The use made by the court below of a catch-all rule to make unlawful, on the basis of a general purpose of the Exchange Act, actions not proscribed by statute or specific regulation does tremendous violence to due process of law.

It subjects petitioner to criminal prosecution for an offense created by judicial fiat in the midst of a criminal case. This use of the purpose of the Act to create a violation is fundamentally at odds with this Court's decision in *Hochfelder, supra.*

The Exchange Act contains a precise definition of what is an unlawful manipulation. The opinion of the court below recognizes that an allegation that stock was sold for the purpose of inducing the purchase or sale of such stock by others is essential to the offense of market manipulation as defined in Section 9(a)(2) of the Exchange Act. Although the prosecution was well aware of this requirement from proceedings on a prior defective indictment, there is admittedly no such allegation in this indictment. The prosecution was unable to charge the offense proscribed by Congress.

The court below attempted to cure the defect by holding that the allegation required by Congress is unnecessary because Rule 10b-5 "operates independently" of the statute, and Section 9 of the statute "cannot be read as a limitation on Rule 10b-5". The court used the general language of Rule 10b-5 to exclude elements from the definition of unlawful market manipulation that Congress specifically included. But in *Hochfelder,* this Court rejected the contention that Rule 10b-5 could be "viewed in isolation" (96 S.Ct. at 1390). It stated that " 'the interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen * * *.' " (*Id.* at 1397). It held that the general language of Rule 10b-5 may not be used to nullify the express and carefully drawn restrictions of the statute. (*Id.* at 1389.)

For this reason, this Court in *Hochfelder* expressly rejected the same contention that the Court of Appeals used as a justification for its decision. In *Hochfelder,* the SEC had argued in terms almost identical to those used

in the opinion below that the broad remedial purposes of the statute permitted the court to proscribe conduct not prohibited by the terms of the statute or rule. Rejecting the notion that a court could "draw on some unexpressed spirit outside the bounds" of the statute to outlaw an "effect" thought to contravene a general statutory purpose (96 S.Ct. at 1383 and 1384, n. 19), this Court held:

> "Rule 10b-5 was adopted pursuant to authority granted the Commission under § 10(b). The rulemaking power granted to an administrative agency charged with the administration of a federal statute is not the power to make law. Rather, it is 'the power to adopt regulations to carry into effect the will of Congress as expressed by the statute.' • • • Thus, despite the broad view of the Rule advanced by the Commission in this case, its scope cannot exceed the power granted the Commission by Congress under § 10(b)." 96 S.Ct. at 1390-91.

The holding of the court below that Section 9 of the Exchange Act is not a limitation on Rule 10b-5 is flatly contrary to *Hochfelder*. By ignoring this Court's teaching in *Hochfelder* the court below created a crime that was of its own making, rather than that of Congress. The rationale of *Hochfelder* has special force in this criminal prosecution, where it cannot be overlooked that "legislatures and not courts should define criminal activity." *United States* v. *Bass*, 404 U.S. 336,, 348 (1971), and where due process requires that fair warning be given, "plainly and unmistakably," that particular conduct is a crime. *Id.*

The decision below invites exactly the kind of "endless case by case" determination, under no standard other than whether the facts alleged constitute conduct that in the court's view violates a general purpose, that this Court found to be improper in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 755 (1975). Like the Ninth Circuit

decision reversed in *Blue Chip*, the lack of any standard makes it all but impossible to weed out, prior to trial, those cases that justify the burden and expense of protracted litigation from those that do not. *Id.* at 739-743. And the lure of appellate review is all but irresistible because one judge's perception of what offends a generalized purpose may well differ from another's. For these reasons as well, an early and definitive decision is necessary to set to rest, once and for all, the troublesome and recurring question as to the substantive reach of Rule 10b-5 and to apply the principles announced in *Hochfelder* to that question.

B. Conflict Between the Circuits: Manipulation as a per se violation of Rule 10b-5

The fundamental defect that permeates the entire opinion of the Ninth Circuit is its failure to correlate the conduct charged in the indictment with the terms of the statute and rule alleged to have been violated. The court below states that clauses (a) and (c) of Rule 10b-5 constitute a "flat prohibition" against "market manipulations". (41a.) But neither clause (a) nor clause (c) of Rule 10b-5 mentions "market manipulations", and the flat prohibition, as the concurring opinion below recognized, is not to be found in the Rule.* (55a.)

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* Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(a) to employ any device, scheme, or artifice to defraud,

* * * *

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

The holding of the Ninth Circuit that Rule 10b-5 contains a flat prohibition against market manipulation conflicts with the decision of the Sixth Circuit in *Marsh* v. *Armada Corporation,* 533 F.2d 978 (6th Cir. 1976), *petition for cert. pending,* No. 76-5, decided after oral argument in the court below but prior to the issuance of the court's opinion and cited to the court in the petition for rehearing. In that case, the Court of Appeals for the Sixth Circuit held that Section 10(b) and Rule 10b-5 do "not flatly prohibit the use of a manipulative device" but rather prohibit only such conduct as, upon analysis, constitutes unlawful deception within the terms of Rule 10b-5. 533 F.2d at 983.

In the *Marsh* case, the Sixth Circuit properly analyzed the conduct at issue so as to ascertain whether it involved unlawful deception. In sharp contrast, the opinion in this case of the Ninth Circuit ignores the specific terms of the statute and rule alleged to have been violated and by so doing creates a crime of its own making. Review by this Court is required to resolve this conflict between the circuits on this important issue.

C. A Second Departure From *Hochfelder*: Scienter

One would have thought that this Court's opinion in *Hochfelder* settled once and for all the necessity of a specific intent to deceive or defraud, at least in a private action under Rule 10b-5. And if that intent is required in a private civil action, then, *a fortiori,* it is a necessary element in a criminal prosecution under the same rule. Nevertheless, the court below decided that Rule 10b-5 requires no specific intent to deceive or defraud and held that an ill-defined generalized intent to do the act that the court finds violates the rule is sufficient.

It is impossible to find any indication in the indictment who it was that petitioner allegedly intended to deceive or

defraud in connection with the purchase or sale of a security. The government claims the victims of the deceit were those who sold their Air West stock when the market price declined. (17a.) That claim is ridiculous. The indictment carefully omits the charge that the sales were made for the purpose of inducing sales by others and thus negates the existence of an intent to defraud or deceive those who may have sold their stock at an allegedly depressed price.

A recent memorandum from the SEC General Counsel to staff attorneys* illustrates the practical consequences that would follow if this Court's holding in *Hochfelder* were eroded in the manner reflected in the decision of the Court of Appeals. The SEC memorandum advises staff attorneys to avoid allegations of scienter in future pleadings except in cases where the staff has evidence that would support the allegations required by this Court. This tactic, says the SEC General Counsel, "will provide the staff with flexibility in proving its case."

The courts should not be burdened with such time-consuming "flexibility of proof" under pleadings calculated to circumvent this Court's requirement of an allegation of intent to deceive. There is no room in *Hochfelder*, particularly as applied to a criminal prosecution, for the kind of "flexibility" sought by the SEC memorandum and reflected in the decision below. There is an urgent need that this Court make clear that the decision in *Hochfelder* may not be circumvented by artful pleading or sophistic distinctions that conceal the absence of an essential element of a statutory offense.

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* The memorandum was published in BNA, Sec.Reg.L.Rep. No. 354 at F-1 (May 26, 1976).

D. The Creation of a Crime by Judicial Fiat: The Misuse of Rule 10b-5 To Supply A Missing Element

Until this case, no court had held that bona fide sales of stock on a national exchange entered into without deception and in accordance with the rules of the Commission and the exchange might constitute market manipulation in violation of the Exchange Act.

According to the Court of Appeals, the practice in question is the making of "certain guarantees against trading losses". (28a.) But neither the court nor the government ever questioned the government's admission in the District Court that a guarantee against loss on the sale of stock is perfectly lawful in itself. (5a.) Indeed, the Court of Appeals recognized that if the sales had the "incidental effect" of depressing the market price of the stock, the guarantees would retain their lawful character. (44a.)

The only identification of what the Court regards as distinguishing the lawful from the unlawful is its statement that

> "• • • the appellees are not charged with trading activities which had the effect of changing market prices (as might any large scale transactions). Rather, appellees are charged with deliberately depressing market prices—a different matter entirely from incidentally depressing prices through trading activities." (44a.)

The Court below never, however, explains or justifies drawing this distinction. Deliberately depressing market prices, instead of incidentally depressing market prices, is a crime simply and solely because the court says it is.

The ramifications of this position are startling. For example, suppose that a rich man owns a sizeable block of stock in a corporation that has large interests in South

Africa. Suppose further that because of his opposition to apartheid he sells this stock with every intention of depressing the price of the stock and thus persuading the Board of Directors of the corporation to stop doing business in South Africa. Suppose he goes further and persuades his friends to sell stock for the same purpose, guaranteeing them against loss. According to the opinion of the court below, he has committed a crime—not because the statute says so but because the court says so.

The position that selling stock for the purpose of depressing the price is a crime becomes even more startling if one looks at the legislative history of the Exchange Act. The court below purported to use legislative history as a guide but ignored the most important part. The original bills considered by the House and Senate *did* proscribe trades on a national securities exchange "when they are made for the purpose of raising or depressing the market price." H. Rep. No. 1383, 73d Cong., 2d Sess. 18 (1934); S. Rep. No. 792, 73d Cong., 2d Sess. 17 (1934). But after an industry representative pointed out that this provision gave "no means by which the average citizen can tell when he is going to fall within the scope of the criminal provision or not"*, the bill was amended to provide that the statute could not be violated unless the transaction was entered into "for the purpose of inducing the purchase or sale of such security by others." Now the position that Congress rejected has become the essence of a new crime created not by Congress, nor even by Commission rule, but by the court below.

In *Ernst & Ernst* v. *Hochfelder, supra,* 96 S.Ct. at 1384, this Court pointed out that manipulation "is and was

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* *Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 Before the Senate Banking and Currency Committee,* 73d Cong. 6510 (1934).

virtually a term of art when used in connection with securities markets", meaning:

> "To force [prices] up or down, as by matched orders, wash sales, fictitious reports * * *; to rig." *Id.* at n. 21.

To manipulate is thus not to force prices up or down, but to do so by particular means that are deceptive. That is why Section 9(a)(2) of the Exchange Act does not make it unlawful to raise or depress the price, and proscribes only cases where that stock is sold for a particular unlawful purpose in a manner calculated to achieve that purpose. The Court of Appeals committed fundamental error when it asserted that it is a criminal manipulation to depress the price, however deliberately, without regard to the means by which the depression in price is accomplished.

As applied to sales of stock, the term of art "manipulation" proscribes a particular manner or means of selling, not the motive of the seller. Each of the particular means referred to in the above-quoted definition from *Hochfelder* is manipulative not because it raises or depresses prices, but because of the way in which it does so. Each of the means enumerated therein deceptively appears to involve a sale. But here the government has conceded that the sales of stock involved were true sales to independent buyers. (26a.) Unlike wash sales and matched orders, they were not artificial.*

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* The true sales of stock involved here are also fundamentally different from the transaction involved in *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970), relied on by the Court of Appeals. In *Crane* an apparent purchaser of stock on the market was financing its purchases with the proceeds of secret sales of the same stock off the market, and thus did not actually acquire ownership of the stock apparently purchased. Here, it is conceded that the sellers divested themselves of ownership of the stock they in fact sold. Therefore, these were true sales, not as in *Crane* sham purchases and sales.

Nor is anything alleged in the indictment or stated in the Court of Appeals opinion that would permit the conclusion that the sales were made in a deceptive or artificial manner. It is not contended that the stock was offered for sale at any price other than that at which independent buyers were offering to buy. Nor is it claimed that there was any collusion among brokers or that the sales were made in any manner other than that in which sales are ordinarily made on the exchange.

As with the above-discussed hypothetical sales for the purpose of inducing the directors of a corporation to change their minds about doing business in South Africa, the sales alleged in this indictment may have depressed the price and may be assumed, for purposes of argument, to have been intended to do so. But they were bona fide sales, which were lawfully executed. There is no statute or regulation that makes such sales unlawful.

The Court of Appeals in effect concedes as much, but asserts that the judicial function in construing Rule 10b-5 is to outlaw whatever "effects" the court regards as contravening the underlying purpose of the securities laws, without regard to the terms of the Rule or of related and interdependent provisions of the Exchange Act. As shown above, this assertion is directly contrary to the principles of construction this Court articulated and applied in the *Hochfelder* case.

This disregard for the Court's teaching in *Hochfelder* constitutes a dangerous source of confusion as to the proper application of Rule 10b-5.

E. The Creation of a Crime by Judicial Fiat: A Denial of Constitutional Rights

If this were only a civil action, the decision below would constitute a departure from principles that this Court has

established. Because this, however, is a criminal proceeding, the decision below involves, in addition, a four-way deprivation of fundamental rights.

1. Due process requires that no person be held criminally responsible for conduct which he could not reasonably understand to be proscribed. *Jordan* v. *DeGeorge*, 341 U.S. 233 (1951). Here, as the concurring opinion below concedes, the court found a criminal violation in conduct "never heretofore branded improper by judicial decision, Commission rule or determination, or explicit Congressional act." (55a.) Here the only test of legality is a court's perception of a generalized purpose. Gone are the requirements "to give adequate guidance to those who would be law-abiding, to advise defendants of the nature of the offense with which they are charged, [and] to guide courts in trying those who are accused." *Musser* v. *Utah*, 333 U.S. 95, 97 (1948).

2. Due process requires that one charged with a crime know what the elements of the crime are so that he can prepare his defense. *See Russell* v. *United States*, 369 U.S. 749 (1962). Even today petitioner can have no firm idea of what the government claims he did that was unlawful. The court below, having created a new crime, never defines it.*

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* The confusion engendered by the opinion of the Court of Appeals as to the application of Rule 10b-5 is nowhere more apparent than in its discussion of a purported violation consisting of a failure of disclosure. (44a-45a.) This discussion appears in a section of the court's opinion entitled "Validity of the Indictment", which follows the section entitled "Rule 10b-5 and Market Manipulation". The court states that "our reading of Counts I and II persuades us" that the indictment does allege a failure to disclose. That fact is that there is no allegation whatsoever in the indictment that the defendants failed to disclose anything to anyone.

(footnote continued on following page)

3. Due process requires that a crime be created by Congress, not by an appellate court's use of a claimed residual power to declare conduct unlawful through an "expansive" reading of a "catch-all" regulation. *United States* v. *Bass,* 404 U.S. 336, 348 (1971).

4. Due process requires indictment by a grand jury. The decision of the court makes meaningless this "basic guarantee of individual liberty". *See United States* v. *Mandujaro,* 96 S.Ct. 1768, 1774 (1976). The grand jury that indicted petitioner could not possibly have understood the elements of the crime for which it indicted him since these elements were only ultimately found in the appellate court's perception of a general statutory purpose.

No wonder Judge Sneed's concurring opinion below warned that, on the basis of the court's opinion, the decision to prosecute or not to proscute "is likely to be one in keeping with the political realities within which [the prosecutor] functions." Judge Sneed termed this part of the price that "this type of statute compels us to pay". But it is the decision of the court, not the statute, that would exact this price—a price that, we submit, is too high in terms of basic rights to be permissible.

(footnote continued from preceding page)

Proceeding on the unsupported factual premise that the indictment alleges a failure to disclose, the Court of Appeals says that the expression of an opinion that the price of Air West stock would decline "without revealing that the decline was not due to the free operation of market forces" is a violation of Rule 10b-5.

The Court of Appeals appears to be creating a new duty of affirmative disclosure—without indicating to whom, when, and in what manner the disclosure must be made—whenever anyone engages in conduct that could affect the market price of a security. Whatever the propriety of creating such duty on the basis of an indictment that does not allege that any duty of disclosure was breached, the imposition of this duty is flatly contrary to this Court's holding in *TSC Industries, Inc.* v. *Northway, Inc.,* 96 S.Ct. 2126 (1976).

Conclusion

For the reasons stated herein, a writ of certiorari should issue to review the opinion and order of the Ninth Circuit.

Respectfully submitted,

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September 6, 1976

Nos. 76-337 and 76-356

In the Supreme Court of the United States

OCTOBER TERM, 1976

CHESTER C. DAVIS, PETITIONER

v.

UNITED STATES OF AMERICA

DAVID B. CHARNAY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
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Solicitor to the Commission,

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ON PETITIONS FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 27a-57a) is reported at 537 F. 2d 341. The order of the district court is unreported (Pet. App. 19a-24a).[1]

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[1]"Pet. App." refers to petitioner Davis' appendix (No. 76-337). References beginning with roman numberals denote the count and paragraph numbers of the indictment. "Pet." refers to the Davis petition. "C. Pet." refers to the Charnay petition (No. 76-356).

JURISDICTION

The judgment of the court of appeals was entered on May 7, 1976. A timely petition for rehearing and suggestion for rehearing *en banc* was denied on July 8, 1976 (Pet. App. 58a-61a). On July 28, 1976, Mr. Chief Justice Burger extended petitioner Davis' time for filing his petition (No. 76-337) until September 6, 1976, and the petition was filed September 3, 1976. On August 4, 1976, Mr. Justice Rehnquist denied petitioner Charnay's request for an extension of time to file his petition (No. 76-356). The petition was filed on September 7, 1976, and accordingly is untimely under Rule 22(2) of this Court's Rules. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether execution of a plan to cause the sale of large blocks of a corporation's stock, including short sales, for the sole purpose of depressing the market price of that stock in order to force a sale of the corporation's assets, is an unlawful manipulative device which violates Section 10(b) of the Securities Exchange Act as implemented by Securities and Exchange Commission Rule 10b-5.

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities and Exchange Act, 48 Stat. 891, 15 U.S.C. 78j(b) and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5, are set forth at pages 2a-3a of petitioner Davis' appendix.

STATEMENT

Petitioners and defendants Howard R. Hughes[2] and Robert A. Maheu were indicted in the United States District Court for the District of Nevada. The indictment

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[2]Mr. Hughes died on April 5, 1976. New York Times, April 6, 1976, p. 1, col. 1.

charged that the defendants had knowingly and wilfully conspired to, and did, use manipulative and deceptive devices involving interstate wire communications to depress artificially the price of the common stock of Air West, Inc. ("Air West"), on the American Stock Exchange, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Securities Exchange Act"), 15 U.S.C. 78j (b) and 78ff, and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5, and of the conspiracy and wire fraud statutes, 18 U.S.C. 371 and 1343 (Pet. App. 8a-11a; I 11, 12, 13, 14).[3]

The allegations of the indictment were as follows:[4] In August 1968, defendant Hughes, who was the sole stockholder of the Hughes Tool Company ("Hughes Tool") (Pet. App. 6a; I 1), instructed defendant Maheu, the chief executive officer of Hughes/Nevada Operations, a company controlled by defendant Hughes and Hughes Tool (Pet. App. 7a; I 3), and petitioner Davis, an attorney who acted as counsel for Hughes Tool (Pet. App. 6a; I 2), to make an offer on behalf of Hughes Tool to purchase Air West by acquiring its assets for cash at a price designed to yield approximately $22 per share to Air West stockholders (Pet. App. 7a-8a; I 8). On or about December 28, 1968, a bare majority of Air West's stockholders voted to accept the Hughes Tool offer (Pet. App. 8a; I 10). That same day, however, Air West's board of directors rejected the offer by a vote of 13 to 11 (Pet. App. 8a; I 10).

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[3]A prior indictment against these defendants had been dismissed by the district court on January 30, 1974 (Pet. App. 48a). The second indictment, which is the subject of this appeal, was returned within the six-month re-indictment period specified in 18 U.S.C. 3288 (Pet. App. 53a).

[4]The allegations of the indictment are assumed to be true for purposes of determining whether the indictment states an offense against the United States. *United States* v. *A & P Trucking Co.*, 358 U.S. 121, 126, n. 5; *United States* v. *Howard*, 352 U.S. 212, 214-215.

Following the rejection, petitioner Davis, and defendants Hughes and Maheu attempted by various means to induce the Air West directors who had voted against the Hughes Tool offer to change their votes (Pet. App. 9a; I 13). As part of this effort, these defendants represented to the stockholders of Air West, and to others, that if the Hughes Tool offer were rejected, the price of the common stock of Air West would decline substantially (Pet. App. 9a; I 14a).

On December 31, 1968, these defendants, with the assistance of petitioner Charnay and certain other persons, conspired to depress the market price of Air West stock on the American Stock Exchange (Pet. App. 9a-10a; I 14a-c). Petitioner Davis and defendants Hughes and Maheu entered into agreements with petitioner Charnay and with unindicted co-conspirators Herman Greenspun and George Crockett, whereby petitioner Charnay, and Greenspun and Crockett were to sell shares of Air West common stock on the American Stock Exchange (Pet. App. 10a; I 14b). Greenspun and Crockett agreed to sell 27,000 shares which they owned. Petitioner Charnay agreed to sell "short" 59,100 shares (Pet. App. 12a; Overt Acts, para. e, g, i). Petitioner Davis, and defendants Hughes and Maheu agreed to reimburse petitioner Charnay for whatever losses he might sustain in his short sales, and they assured Greenspun and Crockett that they would receive $22 for each share they sold, regardless of the price at which their stock was actually sold (Pet. App. 10a; I 14b).[5]

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[5]Further to induce the non-approving directors to change their votes, petitioner Davis, and defendants Hughes and Maheu, that same day, caused telegrams to be sent to those directors threatening them with the institution of lawsuits if they did not change their votes (Pet. App. 11a; I 14d). The threats were carried out when, that same day, petitioner Davis and defendants Hughes and Maheu caused certain Air West shareholders and directors to file lawsuits

All these sales were effected on December 31, 1968 (except that petitioner Charnay was able to sell short only 19,100 shares) (Pet. App. 12; Overt Acts, para. e, g, i). The sale contributed to and caused a decline that day in the price of Air West common stock on the American Stock Exchange from $18 per share to $15.75 (Pet. App. 10a; I 14c).

Later that same day, as a result of defendants' activities, Air West reversed its earlier position and contracted to sell its assets to Hughes Tool (Pet. App. 12a; Overt Acts, para. j).

The district court dismissed the indictment on the ground that it failed to state an offense (Pet. App. 19a-24a). On appeal by the United States, the court of appeals reversed and remanded for further proceedings. It held (Pet. App. 41a):

> Here the Government has alleged that the appellees in selling their Air West stock purposely sought to depress the market for the stock, and in fact achieved this result, with the object and effect of deceiving the shareholders and directors of Air West in Hughes' takeover attempt. Such conduct falls within the type of activity which Congress sought to prohibit in enacting the Securities [and Exchange] Act and which Rule 10b-5 explicitly prohibits. It constitutes an indictable offense.

In an order denying a petition for rehearing and suggestion for rehearing *en banc*, the court held that the indict-

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against the non-approving directors, charging that their rejection of the Hughes Tool offer constituted a breach of the fiduciary obligation they owed to Air West's shareholders (Pet. App. 11a; I 14d-e). Additionally, petitioner Davis and defendants Hughes and Maheu caused the issuance of court orders directing the seizure of the common stock of Air West owned by the non-approving directors (Pet. App. 11a; I 14e).

ment contained allegations "sufficient to charge the requisite intent and scienter under *Ernst & Ernst* [v. *Hochfelder*, 425 U.S. 185]" (Pet. App. 61a).[6]

ARGUMENT

1. Petitioners contend that the court of appeals erred in holding that the indictment states an offense under Section 10(b) of the Securities and Exchange Act (15 U.S.C. 78j(b)) and Rule 10b-5. In the present posture of the case, however, there is no occasion for the Court to consider that contention.

The district court dismissed the indictment, and the court of appeals reinstated it by reversing the dismissal. The case thus is in the same posture as if the district court had denied petitioners' motion to dismiss the indictment. Such an order would not be appealable (*Heike* v. *United States*, 217 U.S. 423; *Parr* v. *United States*, 351 U.S. 513), because such interlocutory determinations do not terminate the litigation; permitting appeals could thus seriously delay expeditious administration of the criminal law. Cf. *United States* v. *Ryan*, 402 U.S. 530; *Cobbledick* v. *United States*, 309 U.S. 323.

Petitioners have shown no extraordinary circumstances that would warrant this Court now to decide the preliminary question whether the indictment charges an offense. Indeed, the Court may never have to decide that question, since petitioners could be acquitted at their trial, or, if convicted, the court of appeals could reverse their conviction on grounds not warranting review here. If and when petitioners are convicted and their conviction is affirmed, the legal issue petitioners raise will have

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[6]The court of appeals stayed its mandate until disposition of these petitions. None of the defendants is in custody.

been clarified and sharpened by the development of a full record detailing the precise nature and effect of their actions. If the Court deems the legal issue sufficiently important to warrant review, that would be the appropriate occasion therefor. Cf. *Heike* v. *United States, supra,* 217 U.S. at 430; *Parr* v. *United States, supra.*[7]

2. The court of appeals correctly held that the indictment charged a violation of Section 10(b) and Rule 10b-5. That ruling did not rest, as petitioners state, "solely on the basis" of some general purpose of the securities laws (Pet. 5; C. Pet. 6), but because the court found that the indictment "alleged that the * * * [defendants] in selling their Air West stock purposely sought to depress the market for the stock, and in fact achieved this result * * *" (Pet. App. 41a).[8] They were accordingly engaged in a "scheme, or artifice to defraud," and an "act, practice, or course of business which operate[d] * * * as a fraud or deceit" upon all other sellers of Air West stock, as well as on its other stockholders and its directors, within the meaning of the quoted terms as used in

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[7]After a trial, if petitioners are convicted, this Court could review the court of appeals' reversal of the district court's dismissal of the indictment. *E.g., Toledo Scale Co.* v. *Computing Scale Co.,* 261 U.S. 399, 418; *Hamilton-Brown Shoe Co.* v. *Wolf Bros. & Co.,* 240 U.S. 251, 257-258.

[8]The district court similarly characterized the allegations of the indictment as charging the defendants with having "cause[d] substantial blocks of a security to be sold on a national securities exchange for the purpose of artificially depressing the market price of the security * * * " (Pet. App. 23a).

Although petitioners state that "[a]ccording to the Court of Appeals, the conduct at issue is 'certain guarantees against trading losses.' (28a.)" (Pet. 15; see also, C. Pet. 14), the quoted portion of the opinion of the court of appeals refers to that court's characterization of the first indictment, not the indictment involved in the present case (Pet. App. 27a-28a).

Rule 10b-5.[9] Their conduct accordingly violated Section 10(b), which makes it illegal to employ, in connection with the purchase or sale of any security, "any manipulative or deceptive device or contrivance" in contravention of the Commission's rules.

Petitioners contend that activities wilfully undertaken for the purpose of raising or depressing the market price of stock do not constitute a manipulation within the meaning of Section 10(b) and Rule 10b-5 unless (1) the activities are entered into for the purpose of inducing the purchase or sale of securities by others, and (2) the activities give the appearance of trading but do not involve actual transactions. As petitioners recognize (Pet. 18; C. Pet. 16), however, those are the elements which are necessary to show a "manipulation of security prices" in violation of Section 9(a)(2) of the Securities Exchange Act, 48 Stat. 889, 15 U.S.C. 78i(a)(2).

If Congress had intended to limit the prohibition against manipulative schemes and devices to those that Section 9 (a) prohibits, it would not have prohibited in Section 10(b) those devices and contrivances that contravene the Commission's rules. Congress deliberately included in the Act both kinds of statutory prohibition against manipulative activity. It authorized the Commission to make the judgment that investors are as seriously injured when security prices are manipulated for a purpose other than inducing purchases and sales of securities by others, which Section 10(b) bars, as when the manipulation has such a purpose and thus falls under Section 9(a)(2).

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[9]Rule 10b-5 makes it unlawful, in connection with the purchase or sale of a security,

(a) To employ any device, scheme, or artifice to defraud,

* * * * *

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person * * *.

Nor are Section 10(b) and Rule 10b-5 limited to manipulative or deceitful devices based on artificial transactions, such as wash sales or matched orders. Those transactions are expressly proscribed by Section 9(a)(1), 15 U.S.C. 78i(a)(1). Section 10(b) was added to the Act, as a "catchall" clause to enable the Commission to deal with " 'any other cunning devices' " by which markets might be manipulated. *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 202 (quoting the testimony of Thomas G. Corcoran, a spokesman for the drafters). Proscribed conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities (*Ernst & Ernst, supra*), may include actual trading. Cf. Section 9(a)(2), 15 U.S.C. 78i(a)(2).

Contrary to petitioners' contention, the decision of the court of appeals does not conflict with the scienter requirement of *Ernst & Ernst* v. *Hochfelder, supra.* That case involved a private claim for damages under Section 10(b) and Rule 10b-5, based on the defendant's allegedly negligent non-feasance. The Court held that a damage action based on these provisions will not lie "in the absence of an allegation of intent to deceive, manipulate, or defraud on the part of the defendant." 425 U.S. at 187-188.

In this case, in contrast, the indictment charges that the defendants "*wilfully and knowingly*" employed "manipulative and deceptive devices" (emphasis added) (Pet. App. 8a-9a; I 12), and that the defendants "*did devise and intend to devise* a scheme and artifice to defraud the directors and stockholders of Air West" (emphasis added) (Pet. App. 14a, 15a; III 2, IV 2). The indictment alleges that petitioners caused "substantial blocks of * * * [Air West stock] to be sold on a national securities exchange for the purpose of artificially depressing the market price of" (Pet. App. 23a)

that stock, and that they "in fact achieved this result, with the object and effect of deceiving the shareholders and directors of Air West * * *" (Pet. App. 41a). The charge in this case, unlike that in *Ernst & Ernst,* was wilfull and knowing misconduct, not mere negligent non-action. As the court of appeals explained in denying rehearing (Pet. App. 60a), it—

> did not hold that scienter *per se* was not a required element of the offense. Rather we noted that it *was necessary for the prosecution to show an intentional act* with "a realization on the defendant's part that he was doing a wrongful act." [Emphasis added.]

Such an intent and realization of wrongdoing are plainly alleged.

The decision of the court of appeals does not conflict with *Marsh* v. *Armada Corp.,* 533 F. 2d 978 (C.A. 6). In *Marsh* the court concluded that an alleged manipulative scheme involving elimination of stock dividends did not violate Rule 10b-5 because there had been complete advance disclosure of the defendants' intention to eliminate dividends; there was, therefore, no deceit or fraud on any persons.

In this case the defendants did not disclose their intention to drive down the market price of Air West stock (Pet. App. 44a). The alleged scheme operated as a fraud on anyone who sold Air West stock during the period when its price was artificially depressed as a result of defendants' activities (Pet. App. 10a; I 14c) since they were the victims of petitioners' scheme to drive the price down. Protection against such conduct is the fundamental purpose of the 1934 Act (*Ernst & Ernst, supra,* 425 U.S. at 195) and of Rule 10b-5 (see n. 9, *supra,* p. 8, and discussion, *supra,* p. 9).

Petitioners claim that the indictment denies their Fifth and Sixth Amendment rights, because Rule 10b-5 does not specify what fraud it proscribes, so that petitioners have "no firm idea of what the government claims [they] did that was unlawful" (Pet. 20-21; C. Pet. 18-19).[10] The Commission adopted the rule, however, precisely because it is impossible to define all of the fraudulent and manipulative schemes devious ingenuity can conceive. Rule 10b-5 prohibits "*all* fraudulent schemes in connection with the purchase or sale of securities whether * * * [n]ovel or atypical." *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 11, n. 7. Petitioners' alleged scheme was fraudulent because it involved a secret device artificially to depress the market price of stock.

Contrary to petitioners' argument, there is nothing novel in the holding of the court of appeals that a market manipulation effected for the purpose of creating an artificial price perpetrates a fraud upon the investing public (Pet. 15-22; C. Pet. 14-19). This holding is reflected in English common law. In *Scott* v. *Brown*, 2 Q.B. 724 (1892), the parties had conspired to purchase shares

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[10]Petitioners' assertion that "[i]t is impossible to find in the indictment who it was that petitioner[s] allegedly intended to deceive or defraud * * * " (Pet. 13; see also, C. Pet. 12-13) ignores the allegations of the indictment that the persons defrauded were, among others, "purchasers and sellers of Air West securities" (Pet. App. 13a; II 2) and "directors and stockholders of Air West" (Pet. App. 14a, 15a; III 2, IV 2), and that as a result of defendants' fraudulent and manipulative activities "Air West" (stockholders who sold their stock in the declining market * * * [received] the proceeds from their sales at artificially depressed prices" (Pet. App. 10a). If petitioners require more definite information they may seek it through a bill of particulars (Pet. App. 47a). Accord, *Tasby* v. *United States*, 504 F. 2d 332 (C.A. 8); *Sullivan* v. *United States*, 411 F. 2d 556 (C.A. 10).

in a company in order to create the appearance of a bona fide market for the shares and that the shares were trading at a premium. The court held the arrangement to be a fraud. See also, *Reg.* v. *Aspinall,* 1 Q.B.D. 730, affirmed, 2 Q.B.D. 48 (1876); *Bedford* v. *Bagshaw,* 4 H. & N. 538, 157 Eng. Rep. 951 (1859); *Rex* v. *DeBerenger,* 3 M. & S. 67, 105 Eng. Rep. 536 (K.B. 1814).

Moreover, prior to the federal securities laws, manipulative activities were held to be unlawful under the federal mail fraud statute. Speaking of a defendant who used a pool to inflate the price of a stock, a district court held: "the substitution of an artificially stimulated and controlled market for an appraisal of the stock in an open and free market" constituted fraud. *United States* v. *Brown,* 5 F. Supp. 81, 84 (S.D. N.Y.), affirmed on other grounds, 79 F. 2d 321 (C.A. 2), certiorari denied *sub nom. McCarthy* v. *United States,* 296 U.S. 650. Similarly, in *Harris* v. *United States,* 48 F. 2d 771 (C.A. 9), a mail fraud case, the court of appeals observed that the violator's "primary purpose * * * was to manipulate * * * stock upon the stock exchanges so that it would have an apparently steadily increasing market value." *Id.* at 775. A distinguished commentator has said of that case that "[t]he cardinal misrepresentation [was] that the price was fixed in a free market, whereas in fact it was fixed by defendant * * *." Berle, *Stock Market Manipulation,* 38 Colum. L. Rev. 393, 397 (1938). Similarly, in the present case, the court of appeals found that the wilfull conduct of defendants in "representing to Air West stockholders and directors that the market would decline if the Hughes tender offer were rejected and their subsequent conduct in driving down the market price without revealing that the

decline was not due to the free operation of market forces * * * operate[d] as a deceit on the market place * * * " (Pet. App. 44a-45a).[11]

CONCLUSION

For the foregoing reasons the petitions for a writ of certiorari should be denied.

Respectfully submitted.

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Solicitor to the Commission,

MELVIN A. BROSTERMAN,
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NOVEMBER 1976.

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[11]Petitioners suggest that this statement by the court of appeals is contrary to *TSC Industries, Inc.* v. *Northway, Inc.*, No. 74-1471, decided June 14, 1976 (Pet. 21-22, n. 7; C. Pet. 19 n.). But *Northway* held only that there is no market manipulation if stock is purchased "wholly independently for proper corporate and investment purposes * * *" (slip op. 24).

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